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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, DC 20554

Re: Ex Parte Presentation
IB 96-261 International Settlement Rates

Dear Mr. Caton:

On Tuesday, July 29, 1997, Charles Meyers, Larry Lafaro, Kristen Thatcher and I of AT&T and Dr. William Lehr of Columbia University on behalf of AT&T, met with Diane Cornell, Kathy O'Brien and Mark Uretsky of the International Bureau to discuss AT&T's views as previously filed in this docket.

Due to the lateness of the day two copies of this Notice are being submitted on the following business day to the Secretary of the Federal Communications Commission in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Douglas W Schoenberger

Attachment

cc: Diane Cornell
Kathy O'Brien
Mark Uretsky

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Recycled Paper

Foreign Entry, Anticompetitive Behavior, and the Need for Cost-based International Settlement Rates,

Presentation to the International Bureau, Federal Communications Commission

July 29, 1997

Dr. William Lehr

(Columbia University)

on behalf of AT&T

FCC should require cost-based settlement rates as precondition for all foreign entry

Presentation Outline

- Competition: the new regulatory paradigm
- Excessive settlement rates harm consumers and competition
- Foreign entry and the danger of a *price squeeze*
- Requiring cost-based settlements as a precondition for foreign entry is the optimal policy

Competition: the new regulatory paradigm

- Local competition and Telco Act of 1996
  - long distance already effectively competitive, but local remains a monopoly
  - access to monopoly inputs via network unbundling at cost-based rates
  - elimination of implicit subsidies (access and universal service reform)
- WTO Agreement and international competition
  - limited competition in foreign markets
  - need to eliminate settlement subsidy
  - importance of US leadership

Excessive settlements harm consumers

- Prices exceed economic costs
  - US and foreign consumers harmed directly
  - excessive prices for essential input distorts competition
- Subsidy abroad to foreign carriers
- Encourage inefficient bypass
  - but, this is remedy in short-run
- Fund for anticompetitive activity
  - entry to US markets; protect and extend market power; raise rivals' costs
- Reduced incentive to comply with WTO

Danger of a price squeeze

- Motivation
  - increase settlement subsidy
  - finance entry into US markets
  - raise rivals' costs (in US and abroad)
- Opportunity
  - settlements paid by foreign entrant to parent are internal transfer payment
  - excessive settlements fund below-cost pricing
  - overall effect is to harm competition, thereby harming consumers
  - attractiveness unaffected by mode of entry -- resale may be even more attractive

Exhibit 2: Market Impact of Foreign Entry

"Foreign carrier acquires 10% of US market and stimulates $0.10 per minute price cut"

	Base case: before entry		Post-entry: after price cut		
	US industry	Foreign Carrier	US industry (except foreign sub)	US-based foreign subsidiary	Foreign carrier
Revenues					
Outbound traffic	$400,000		$317,250	$ 35,250	
Settlements		$250,000			$293,750
Resale revenue					
Costs					
Wholesale costs	$100,000	$100,000	$105,750	$ 11,750	$117,500
Retail-level costs	$ 50,000		$ 52,875	$ 5,875	
Settlements	$250,000		$264,375	$ 29,375	
Reseller costs					$117,500
Total Costs	$400,000	$100,000	$423,000	$ 47,000	
Excess profit(loss)	$0	$150,000	($105,750)	($ 11,750)	$176,250
Assumptions:					
Minutes outbound[1]	1,000,000		1,057,500	117,500	
Wholesale costs[2]	$0.10				
Retail-level costs[2]	$0.05				
Settlement rate[2]	$0.25				
Wholesale price[2]	$0.35				
Resale price[2]	$0.40		$0.30		
Elasticity	0.7				
Share US Market	100%		90%	10%	

[1] Price cut of $0.10 is 25% price cut. With elasticity of 0.7, this stimulates 175,000 additional minutes. For ease of computation this example ignores inbound traffic.

[2] Per minute.

Exhibit 3 : Market Impact of Foreign Entry via resale

"Foreign carrier acquires 10% of US market and stimulates $0.10 per minute price cut"

	Base case: before entry		Post-entry: after price cut entry via resale		
	US industry	Foreign Carrier	US industry (except foreign sub)	US-based foreign subsidiary	Foreign carrier
Revenues					
Outbound traffic	$400,000		$317,250	$ 35,250	
Settlements		$250,000			$293,750
Resale revenue			$41,125		
Costs					
Wholesale costs	$100,000	$100,000	$117,500		$117,500
Retail-level costs	$ 50,000		$ 52,875	$ 5,875	
Settlements	$250,000		$293,750		
Reseller costs				$ 41,125	$117,500
Total Costs	$400,000	$100,000	$464,125	$ 47,000	
Excess profit(loss)	$0	$150,000	($105,750)	($ 11,750)	$176,250
Assumptions:					
Minutes outbound[3]	1,000,000		1,057,500	117,500	
Wholesale costs[4]	$0.10				
Retail-level costs[2]	$0.05				
Settlement rate[2]	$0.25				
Wholesale price[2]	$0.35				
Resale price[2]	$0.40		$0.30		
Elasticity	0.7				
Share US Market	100%		90%	10%	

[3] Price cut of $0.10 is 25% price cut. With elasticity of 0.7, this stimulates 175,000 additional minutes. For ease of computation this example ignores inbound traffic.

[4] Per minute.

"Price Squeeze" Summary

- Vertically-integrated foreign carrier profits by forcing US carriers to incur anticompetitive losses
  - Strategy works because foreign-affiliate in US incurs only small part of loss imposed on industry
  - Anticompetitive pricing and inefficient subsidies harm consumers
- Settlements at top of benchmark range do not eliminate danger -- need settlements at cost
- Higher settlements, smaller market share, or more elastic demand, then more effective is strategy
- Resale may be most attractive way to implement
  - Faster, less capital intensive, lower cost
- Multiple motivations, not just market power in US LD
- **To solve, require settlements at cost for foreign entry**

Other options?

- Rely on competition to solve? Yes, but must protect competitive process during transition
- Additional restrictions to deter uneconomic bypass? But this is market's self-correcting response.
- Price regulation (review foreign tariffs)? Inefficient
- Other post hoc remedies?
  - Foreign carrier gains until FCC acts
  - Information asymmetry: detection, proof, and enforcement more difficult in international context
  - Critical juncture in US and international competitive process: damage now may not be reversible

Benefits of cost-based settlements

- Promotes economic efficiency and encourages efficient entry
- Best competitive safeguard: eliminates incentive and opportunity to exploit inefficient subsidies
- Not binding on anyone who equally serious as US regarding implementation of WTO
- Simple and improves information to encourage compliance with WTO and US pro-competitive policies
- Foreign entry requirement provides carrot to induce faster adjustment of settlements